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(41)

No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

REPLY BRIEF

STANLEY M. GROSSMAN
Counsel of Record
MARC I. GROSS
JOSHUA B. SILVERMAN
POMERANTZ HAUDEK BLOCK
GROSSMAN & GROSS LLP
100 Park Avenue
26th Floor
New York, NY 10017
(212) 661-1100
Attorneys for Petitioner

211158

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

STATEMENT PURSUANT TO RULE 26.9

Petitioner's corporate disclosure statement was set forth on page ii of its Brief on the Merits. There are no amendments to that statement.

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INTRODUCTION

1. The question presented in this case is whether the text of Section 10(b) and Rule 10b-5 encompasses respondents' alleged conduct, or whether that conduct amounts to no more than aiding and abetting. The court of appeals ruled that because respondents "[did] not make or affirmatively cause to be made a fraudulent misstatement or omission," they did not commit a "deceptive device or contrivance" in violation of Section 10(b) and were "at most guilty of aiding and abetting," not actionable under *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). Pet. App. 9a.

Our opening brief demonstrated that this conclusion is wrong; respondents' own conduct violated the plain language of Section 10(b). They entered into sham agreements to create the illusion that they had purchased advertising from Charter, then manufactured a false paper trail to mislead Charter's auditors regarding those transactions. SAC ¶¶ 97, 102-03, 110, J.A. 54a, 57a, 59a-60a. The Solicitor General agrees that the "court of appeals erred by concluding that petitioner had failed to satisfy Section 10(b)'s deception requirement." U.S. Br. 9. "When measured against the correct standard," respondents' own conduct "constituted a 'deceptive device or contrivance.'" *Id.* at 16.

This conclusion is sufficient to resolve this case. The issue on which the Court granted certiorari – the issue that divides the courts of appeals – is whether deceptive conduct like respondents' constitutes a violation of Section 10(b). Respondents, no doubt sensing the weakness of their position given the plain language of Section 10(b) and *Central Bank*'s holding that the language of the statute governs, introduce a cornucopia of other arguments. *See, e.g.*, Resp. Br. 22-23, 23-24, 26-28. All are without merit. More importantly, they were manifestly not the basis of the court of appeals' decision, and were raised only glancingly below. While these arguments may

be available to respondents on remand, they should not be considered at this time.

2. The non-textual argument that respondents emphasize most heavily (indeed, much more heavily than any argument based on the text) is the assertion that the claim in this case does not satisfy reliance. We respectfully submit that this Court should not decide the reliance question in this case but should instead wait for a case in which that issue is squarely presented and fully briefed.

The issue of reliance plainly was not the basis for the court of appeals' decision. Reliance in securities fraud cases is a complex issue. As this Court observed in *Basic Inc. v. Levinson*, 485 U.S. 224, 243-44 (1988), "positive proof of reliance" is not always required, and the "understanding of Rule 10b-5's reliance requirement must encompass the[] differences" between "modern securities markets" and "the face-to-face transactions contemplated by early fraud cases." (footnote omitted).

Respondents and the Solicitor General urge a position on reliance that would effectively amend Section 10(b) to eliminate its prohibition of a broad range of "deceptive device[s] [and] contrivance[s]" that the Solicitor General concedes are encompassed by its plain language. Only materially false statements and omissions would be banned. This position conflicts with *Basic* and the views of the SEC. U.S. Br. 23 n.13. The SEC voted to submit a brief supporting petitioner in this appeal and confirming the positions on reliance and the availability of scheme liability set forth in amicus briefs it filed in *Simpson v. AOL Time Warner Inc. (Calif. Teachers Ret. Sys. v. Homestore.com, Inc.)*, 452 F.3d 1040 (9th Cir. 2006), *petition for cert. pending*, No. 06-560 (filed Oct. 19, 2006). *See* Test. of Christopher Cox, App.1-7 to Conyers/Frank Br.

In these circumstances – where a complex and novel issue was not decided by the court of appeals, and where a decision by this Court could have a dramatic and adverse effect on the meritorious private securities litigation it has long recognized

to be "an essential supplement" to criminal and civil enforcement proceedings (*see Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504 (2007)) – the Court should reserve judgment until the issue is more squarely presented.

3. In any event, respondents' and the Solicitor General's reliance arguments are erroneous. As the Court noted in *Basic*, the purpose of reliance is to "provide[] the requisite causal connection between a defendant's misrepresentation," or other violation of Section 10(b), "and a plaintiff's injury." 485 U.S. at 243. Here, there is causation, both "but for" and proximate. Petitioner relied upon financial statements recognizing respondents' sham revenues, and the auditor's certification of those statements. It is of no consequence that investors were unaware of the source of the revenue; financial statements rarely provide such details. What is important is that respondents anticipated that the phony figures would be disseminated by Charter and certified by its auditors, and would influence investors' decisions. Reporting $17 million in sham revenues to investors was the very purpose of the deceptive scheme. Misleading Charter's auditors was a crucial means to that end.

Respondents and the Solicitor General appear to take the view that reliance can be satisfied only when a defendant directly conveys a false statement to the public. *See* U.S. Br. 22; Resp. Br. 17. This view is inconsistent with the language of Section 10(b). As the Solicitor General recognizes, Section 10(b) applies to "any person" who "employ[s]" a "deceptive device or contrivance"; it is not limited to entities that convey information directly to investors. U.S. Br. 16-17. Moreover, *Basic* holds that reliance may be established even if a plaintiff was wholly unaware of a fraudulent statement, and emphasizes the need for flexibility in determining reliance in a Rule 10b-5 action. 485 U.S. at 242-44. The rigid position taken by respondents and the Solicitor General conflicts with the statute and this Court's decisions.

Respondents assert that their position is based on what they call "the reliance requirement" of *Central Bank*. Resp. Br. 13. But there is no such animal. Reliance was not at issue in *Central Bank*. That decision emphasizes the central importance of the language of Section 10(b) and holds that the text does not support liability for mere aiding and abetting. *See* 511 U.S. at 173-78. Its discussion of reliance is limited to one paragraph, which recognizes that *Basic* defines the contours for the requirement and mentions reliance only to point out that aiders and abettors did not need to establish reliance to proceed under that theory. 511 U.S. at 180.

Respondents repeatedly raise the specter that a ruling in favor of petitioners on the reliance issue in this case will effectively reinstate aiding and abetting liability. But what precludes aiding and abetting liability is the language of Section 10(b) requiring deceptive conduct. *Central Bank* could not have made this point more explicitly. Conduct encompassed by the plain language of Section 10(b), as the Solicitor General concedes is the case with respondents' conduct here, constitutes a primary violation of the Act, not aiding and abetting. A judge-made expansion of the reliance requirement to immunize such conduct from liability would thwart, rather than serve, the purpose and the plain language of Section 10(b).

In the end, the excessively strict reliance requirement advocated by respondents and the Solicitor General would simply place an arbitrary limit on claims permitted by the plain language of Section 10(b) and this Court's decisions. Respondents and the Solicitor General argue at length that such a limitation is desirable as a policy matter. But when Congress comprehensively addressed private litigation under the Exchange Act just a decade ago, it left intact the relevant language of Section 10(b) and *Basic*'s flexible reliance requirement. If respondents and the Solicitor General believe

private enforcement of Section 10(b) should be further restricted, they should address their arguments to Congress, not to this Court.

ARGUMENT

I. Respondents' Own Deceptive Conduct Violated Section 10(b).

As we show in our opening brief, and as the Solicitor General agrees, respondents' own conduct alleged in the Second Amended Complaint unquestionably constitutes "deceptive device[s] or contrivance[s]" within the meaning of Section 10(b). Pet. Br. 6-12, 36-37; U.S. Br. 8, 16-17.

Such deceptive conduct can be readily distinguished from legitimate business activity and mere aiding and abetting. The test proposed by petitioner, for example, would require: (1) a deceptive act by the defendant itself; (2) creating a false appearance of material fact; (3) in furtherance of a scheme to defraud investors. Pet. Br. 32.[1] A plaintiff would also have to plead a strong inference of scienter in accordance with the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4, and *Tellabs*. The proposed test is not "nebulous" or "untethered," as respondents and their amici incorrectly assert. Courts applying similar tests have had no difficulty distinguishing between deceptive conduct and aiding and abetting, and have dismissed aiding and abetting claims at the pleading stage. *See, e.g.*, *Simpson*, 452 F.3d at 1052-55; *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 504-05 (S.D.N.Y. 2005).

[1] The indenture trustee in *Central Bank* would not face liability under petitioner's test. As was conceded in that case, the indenture trustee did not commit its own deceptive act. 511 U.S. at 191. It did not furnish the false appraisal or certify its accuracy at the time of the 1988 offering. *Id.* Moreover, as the court of appeals found, the trustee complied with the indenture and owed no duty of disclosure. *First Interstate Bank, N.A. v. Pring*, 969 F.2d 891, 901 (1992), *rev'd on other grounds sub nom. Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). It merely failed to obtain an additional appraisal before it was required by the indenture, which may have exposed the developer's fraud. 511 U.S. at 191.

II. Charter's Investors Relied Upon The False Appearance Of Fact Created By Respondents' Deceptive Conduct.

As discussed above, the Court can and should determine this appeal on the question presented alone: "As a general rule . . . we do not decide issues outside the questions presented by the petition for certiorari." *Glover v. United States*, 531 U.S. 198, 205 (2001). However, because respondents and the Solicitor General emphasize so heavily in their briefs reliance and other issues not resolved below, and because we have not previously had occasion to address them directly, we address here why these arguments cannot present alternative grounds for affirmance.

1. The term "reliance" does not appear in § 10(b), Rule 10b-5, or the pleading requirements of the PSLRA. As fashioned by the Court, reliance in § 10(b) actions requires only allegations of "the requisite causal connection" between a defendant's fraud and a plaintiff's injury. *Basic*, 485 U.S. at 243. This nexus may be established by reliance on "other deceptive conduct" or "actions," as well as misrepresentations. *Central Bank*, 511 U.S. at 180; U.S. Br. 19.[2]

"There is . . . more than one way to demonstrate the causal connection." *Basic*, 485 U.S. at 243. *Basic* recognized that securities are traded in markets that anonymously transmit information "in the processed form of a market price." *Id.* at 244. Investors presumptively rely on any fraud impacting that price, whether or not they know the identity of the perpetrator

[2] Though the Solicitor General criticizes petitioner for equating reliance with "but for" causation (U.S. Br. 20), that is exactly what reliance means: "In the securities realm, 'but for' causation is referred to as 'reliance, or transaction causation,' and 'proximate cause' is known as 'loss causation.'" *Berckeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 222 (3d Cir. 2006). His assertion that "but for" causation "does not distinguish primary from secondary liability" is equally misplaced. U.S. Br. 20. What distinguishes primary liability from secondary liability is whether a defendant itself committed deceptive acts proscribed by § 10(b).

or even the nature of the fraud. *Id.* at 244-47. In fact, the manipulative conduct also proscribed by § 10(b), by definition, can only induce indirect reliance on market price. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977); *Stephenson v. Deutsche Bank AG*, 282 F. Supp. 2d 1032, 1056 (D. Minn. 2003). Indirect reliance is similarly recognized in common law. Restatement (Second) of Torts, § 533 (1976) provides that one who makes a fraudulent statement can be held liable not only by direct recipients, but also by those persons to whom he "intends or has reason to expect that its terms will be repeated or its substance communicated."

Though *Central Bank* cited *Basic* as setting forth the correct standard for reliance, respondents focus instead on this subsequent remark: "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180. But the Court's observation reflects only that lower court decisions allowed imposition of aiding and abetting liability *without any proof of reliance*. All that they required was proof that a secondary actor had knowingly and substantially assisted a primary violation. *See, e.g., K&S Partnership v. Cont'l Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991), *cert. denied*, 505 U.S. 1205 (1992).

Nonetheless, respondents and the Solicitor General suggest that *Central Bank* endorsed a "bright line rule" categorically precluding investors from claiming they relied on the deceptive conduct of unknown secondary actors. Resp. Br. 30. But *Central Bank* says no such thing, and that leap of logic is flatly inconsistent with *Basic*, which contemplates that investors can rely on any material information entering the market, regardless of how it got there.[3] *See also United States v. O'Hagan*, 521

[3] The auditor cases cited in the Solicitor General's brief at 21-22 all involved accountants that did not commit their own deceptive acts, but merely failed to blow the whistle on management's fraud. See *Fidel* (Cont'd)

U.S. 642, 656 (1997) ("[A] fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons.") (quotation and citation omitted).

In scheme cases, reliance "is satisfied if the introduction of misleading statements into the securities market was the intended end result of a scheme to misrepresent revenue." *Simpson*, 452 F.3d at 1051; *see also* SEC Reply Br. in *Simpson* at 12 (reliance "is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act") <http://tinyurl.com/39qg44>; *Parmalat*, 376 F. Supp. 2d at 509 (reliance established where banks knew that "the very purpose of . . . their transactions" was to allow an issuer to convey a misrepresentation into securities markets). The Second Amended Complaint easily satisfies this standard.

The causal chain is not severed because Charter issued the inflated financial statements. The scheme was "not . . . complete until the fraudulent information ha[d] entered the securities market." *Simpson*, 452 F.3d at 1051. "Certainly where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation." SEC Br. in *Simpson* at 22 <http://tinyurl.com/34dmjy>.

Common law principles require the same conclusion, limiting "superseding" causes to those of independent origin that were not foreseeable. *See, e.g.*, 1 DAN B. DOBBS, THE LAW OF TORTS 462 (2001); *Archer v. Warner*, 538 U.S. 314, 326 (2003) (Thomas, J., dissenting). Here, respondents anticipated and intended the resulting publication of false financial statements to investors.

(Cont'd)

v. Farley, 392 F.3d 220 (6th Cir. 2004), *Wright v. Ernst & Young, LLP*, 152 F.3d 169 (2d Cir. 1998), and *Shapiro v. Cantor*, 123 F.3d 717 (2d Cir. 1997). To the extent that these cases suggest that *Central Bank* would immunize the auditors from liability if they did commit their own deceptive acts, they misread the Court's decision and the plain language of Section 10(b).

2. Respondents do not dispute that the false appearance they created added $17 million in phony revenue and operating cash flow ("OCF") to the financial statements Charter published.[4] As public companies themselves, respondents knew that Charter was required by law to publish quarterly and annual financial statements reporting revenues and OCF, and understood that the very purpose of the sham transactions was to inflate those figures.[5] *See* SEC Regulation S-X, 17 C.F.R. § 210. Congress and the SEC anticipated that investors would rely on those financial statements, requiring their publication "*for the proper protection of investors* and to insure fair dealing in the security." 15 U.S.C. § 78m(a) (emphasis added).

Because the fraud here occurred in the fourth quarter, and annual financial statements must be audited, the sham nature of the transactions had to be concealed from Charter's auditors. Again, respondents' deceptive acts were critical. As the Solicitor General acknowledges, respondents' false paper trail was intended to, and did, mislead Charter's auditors regarding these transactions. U.S. Br. 8. Respondents do not suggest any other intent. *See* Resp. Supp. Br. 3 (arguing that it is irrelevant whether their transactions "misle[]d Charter's outside accountants").[6]

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[4] This result did not depend on any complex accounting treatment. No accounting convention allows recognition of revenue for goods or services secretly paid for with the seller's own money.

[5] Respondents' assertion that they did not falsify their own financials is irrelevant. As alleged, the scheme was designed and intended to inflate Charter's financials, not those of respondents.

[6] The indictment in *United States v. Barford*, No. 4:03 CR 00434 (E.D. Mo. July 24, 2003), ¶¶ 22-23 <http://tinyurl.com/2pwrwk>, confirms respondents' knowledge and intent. Though respondents on page 9 of their brief blur together parts from two separate paragraphs of the indictment to suggest a meaning entirely different from the actual text, the indictment itself leaves no doubt that Respondents understood how the scheme was to operate and the role their own deceptive conduct played in misleading Arthur Andersen.

By misleading Charter's auditors, respondents knew that they were endangering investors. The auditing of financial statements is required "for the proper protection of investors." 15 U.S.C. § 78m(a); *see also United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) (auditors serve as a "public watchdog" for investors). "The significance of . . . audit reports to investors in this country is beyond question." *Teachers' Ret. Sys. v. A.C.L.N., Ltd.*, No. 01 Civ. 1184, 2003 U.S. Dist. LEXIS 7869, at *9 n.6 (S.D.N.Y. May 9, 2003). Investors use audited financial statements "to make voting and investment decisions." SEC Final Rule 13b2-2: Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,828 (May 28, 2003).[7]

The causal chain alleged in the Second Amended Complaint is by no means attenuated. The deception of investors through falsified financial statements flowed directly from respondents' sham advertising "purchases" and their deception of the accountants engaged to audit those statements.

3. Neither respondents nor the Solicitor General dispute that the fraudulent financial statements reflecting the $17 million in phony advertising revenues reached investors. *See, e.g.*, SAC ¶¶ 143, 145, J.A. 75a-78a. Nor do they contest, as this Court explained in *Basic*, that Congress designed the Exchange Act to reflect its understanding that *all* false material information can impact the price investors pay for stock. *See* 485 U.S. at 245-46 (quoting H.R. Rep. 1383 (1934) for the proposition "that the market price of shares traded on well-developed markets reflects all publicly available information" and that "the hiding

[7] Respondents' supplemental brief misstates that Rule 13b2-2 and its authorizing statute, Section 303 of the Sarbanes-Oxley Act of 2002, are the "exclusive" remedies for their fraudulent conduct. Resp. Supp. Br. 3. But the statute itself says the exact opposite, directing the SEC to prepare *supplemental* investor protection rules: "No preemption of other law. The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder." 15 U.S.C. § 7242(c).

and secreting of important information obstructs the operation of the markets").

However, contrary to this understanding, they argue that the fraud-on-the-market presumption should be artificially limited to statements conveyed directly to the market by a given defendant. That arbitrary limitation does violence both to the reasoning of *Basic* and to the plain text of § 10(b), which proscribes deceptive conduct employed "directly or indirectly." 15 U.S.C. § 78j(b); *see also Simpson*, 452 F.3d at 1051 (fraud-on-the-market applies equally to scheme liability claims brought under Rule 10b-5(a) and (c)) (citing 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD, § 7:469 (2d ed. 2006)). At any rate, as the Solicitor General acknowledges, fraud-on-the-market is generally considered at the class certification stage rather than the pleading stage. U.S. Br. 24 n.14.

4. As alleged, the scheme's $17 million inflation of revenues and OCF was both qualitatively and quantitatively material. It made the difference between meeting and severely missing analyst expectations in the fourth quarter of 2000. SAC ¶ 143, J.A. 75a-77a. Moreover, the boost constituted *50%* of Charter's much-touted sequential OCF growth for the fourth quarter of 2000, demonstrating numerical significance.[8] Compare SAC ¶ 143 with ¶ 140, J.A. 74a-77a.

III. The Complaint Adequately Alleges Loss Causation.

The Second Amended Complaint also alleges loss causation. This case is at the pleading stage, which only requires a plaintiff "to provide a defendant with some indication of the

[8] Respondents and the Solicitor General misstate SEC Staff Accounting Bulletin ("SAB") 99 as recognizing a 5% threshold for materiality. In fact, SAB 99 states that "exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law," and specifically indicates that a lower percentage will be material where, as here, it "hides a failure to meet analysts' consensus expectations." 64 Fed. Reg. 45,150, 45,152 (Aug. 12, 1999).

loss and the causal connection that the plaintiff has in mind." *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 347 (2005).[9] The Second Amended Complaint alleges that Charter's stock fell 13% after an analyst raised concerns about "accounting practices, including . . . marketing deals with equipment vendors." SAC ¶¶ 178-79, J.A. 94a-96a. Moreover, it alleges that Charter's stock fell further after the risks created by the fraudulent scheme materialized. *See, e.g.*, SAC ¶ 181, J.A. 96a-97a (stock fell after Charter received a grand jury subpoena related, in part, to matters raised by this analyst); SAC ¶ 184, J.A. 97a (stock fell after Charter executives who designed scheme were forced to resign and Charter announced it would restate financials following a review of these matters). Thus, respondents have been provided the "indication" required by *Dura*.

Petitioner does not, as respondents incorrectly assert, seek to hold them liable for a $7 billion, multi-faceted scheme. As the Second Amended Complaint makes clear, respondents are liable only for losses caused by the fraudulent scheme to boost Charter's fourth quarter and year-end 2000 revenues and OCF. They are not charged with responsibility for the other schemes in which Charter engaged. Further, aggregate damages in the case do not approach the fantastical $7 billion suggested by respondents. As the district court explained, the $146.25 million partial settlement that it approved constituted "32% to 93%" of estimated recoverable damages. 2005 U.S. Dist. LEXIS 14772, at *21 (E.D. Mo. June 30, 2005). Respondents' maximum potential liability would be only a portion of the difference between those estimated damages and the settlement.

Congress addressed this issue in the PSLRA by requiring apportionment of liability. Courts in most cases must consider:

[9] Respondents and their amici conflate the proximate causation required by *Dura* with sole causation. *See e.g.*, Resp. Br. 33. As we show, this restrictive reading violates Congressional intent to apportion liability equitably among the multiple participants in a complex securities fraud. 15 U.S.C. § 78u-4(f)(3)(C).

(1) "the nature of the conduct" of each defendant; and (2) "the nature and extent of the causal relationship between the conduct of each such person and the damages incurred." 15 U.S.C. § 78u-4(f)(3)(C).

IV. Only Congress Can Carve Out A Safe Harbor Protecting Violators Of Section 10(b) And Rule 10b-5(a) And (c) From Civil Liability.

For sixty-five years, § 10(b) and Rule 10b-5(a) and (c) have banned schemes to defraud and business practices that operate as a fraud. 17 C.F.R. § 240.10b-5. When this Court confirmed the existence of a private cause of action, it did so for § 10(b) and Rule 10b-5 generally, not for a limited subset thereof. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). Similarly, when Congress recognized the "federal statutory claim" with the PSLRA, *see Tellabs*, 127 S. Ct. at 2512,[10] it left intact all the prohibitions set forth in § 10(b) and Rule 10b-5.

Accordingly, as this Court explained in *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, a private action can be brought for any of the "four kinds of manipulative or deceptive devices to which [Rule 10b-5] refers." 532 U.S. 588, 593 (2001). Petitioner's claims seek redress because respondents themselves engaged in two of these four kinds of deceptive conduct – a scheme to defraud and business practices operating as a fraud. 17 C.F.R. § 240.10b-5(a) and (c). No amount of repetition can render those claims an "extension" of existing law. Petitioner's claims fall squarely within the statute and rule as written.

In contrast, respondents seek judicial nullification. They improperly suggest that this Court, for policy reasons, transform *Central Bank* into a "bright line rule" immunizing deceptive conduct under Rule 10b-5(a) and (c), unless such conduct

[10] *See also Dura*, 544 U.S. at 346 (the PSLRA "makes clear Congress' intent to permit private securities fraud actions" under § 10(b) where, as here, the requisite elements are alleged).

consists only of a direct misrepresentation or omission. Resp. Br. 30. But as this Court recognized in *Tellabs*, shaping the contours of the private cause of action is now a job for Congress: "*It is the federal lawmaker's prerogative . . . to allow, disallow, or shape the contours of – including the pleading and proof requirements for – § 10(b) private actions.*" 127 S. Ct. at 2512 (emphasis added).[11]

Congress decided to shape the § 10(b) action by requiring heightened pleading of fraud and scienter, barring most state law securities class actions, staying discovery while a motion to dismiss is pending, and protecting those who play a smaller role in schemes to defraud by limiting their liability. 15 U.S.C. § 78u-4; 15 U.S.C. § 78bb(f). Though Congress also created certain safe harbors, *see, e.g.*, 15 U.S.C. § 78u-5, it chose not to amend Section 10(b) to immunize schemes to defraud. Any further safe harbors can only be adopted by Congress. *Tellabs*, 127 S. Ct. at 2512.[12]

V. Respondents' Textual Arguments Do Not Place Their Own Deceptive Conduct Outside Of The Broad Scope Of Section 10(b) And Rule 10b-5.

Unable to meaningfully dispute that their own conduct was deceptive, respondents raise a series of misplaced textual arguments attempting to avoid the broad prohibitions of § 10(b) and Rule 10b-5.

First, respondents' argument that vendors and business partners are somehow beyond the scope of § 10(b), Resp. Br.

[11] Most of the "contours" of private securities litigation that were previously shaped by this Court's decisions are now addressed by statute. *See, e.g.*, 15 U.S.C. § 78aa-1 (statute of limitations); 15 U.S.C. § 78u-4(f) (right of contribution); 15 U.S.C. § 78u-4(b)(2) (pleading of scienter); 15 U.S.C. § 78u-4(c) (purchaser/seller requirement).

[12] Representative Barney Frank, Chair of the House Committee on Financial Services, states that the Committee is willing to hold hearings to consider the safe harbor proposed by respondents. Conyers/Frank Br. 8.

29-31, does violence to both the text and structure of the statute. Section 10(b) prohibits deceptive conduct by "any person," a term "obviously meant to be inclusive," and eschews the limited categories used to restrict other provisions. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

Second, respondents' suggestion that § 10(b) proscribes only direct fraudulent conduct, Resp. Br. 26-28, is rejected by the very text of the statute, prohibiting "any person, *directly or indirectly*" from using or employing deceptive devices or contrivances. Respondents incorrectly posit that this language refers only to the manner in which the mails or wires are used. Resp. Br. 27. That conflicts with *Central Bank*, where this Court found that aiding and abetting liability was inconsistent with § 10(b) because it applied to persons who did not even indirectly engage in the conduct that section proscribes. 511 U.S. at 176; *see also Simpson*, 452 F.3d at 1049; *SEC v. Mandaci*, No. 00 Civ. 6635, 2004 U.S. Dist. LEXIS 19143, at *22 (S.D.N.Y. Sept. 27, 2004); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 862 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998) (all discussing direct or indirect use of a deceptive device or contrivance).[13]

Third, respondents submit that the terms "use or employ" do not embrace their alleged conduct, which they describe as passive. This mischaracterizes the Second Amended Complaint, which details respondents' own deceptive acts.[14]

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[13] *Jama v. Immigration & Customs*, 543 U.S. 335, 343 (2005), cited by respondents, also undermines their tortured construction. *Jama* does state that a limiting clause modifies only the phrase it "immediately follows," but in § 10(b), the term "directly or indirectly" *immediately follows "any person,"* not the jurisdictional clause.

[14] Respondents further mischaracterize the allegations of the Second Amended Complaint in arguing they owed no "duty" to investors. Respondents are not charged with violating a general duty of disclosure. Rather, they are charged with affirmatively employing a deceptive device or contrivance in violation of § 10(b), a prohibition that applies to "any person," with or without a pre-existing duty.

Fourth, Sections 9 and 18 of the Exchange Act that "are close in structure, purpose, and intent to the 10b-5 action," actually support petitioner's position. *Musick, Peeler & Garrett v. Employers Ins.*, 508 U.S. 286, 295 (1993). Both § 9 and § 18 explicitly contemplate private claims against culpable third parties collaborating in the proscribed activities. *See* 15 U.S.C. § 78i(e) ("Any person who willfully participates" in a manipulative transaction can be subject to private liability); 15 U.S.C. § 78r(a) ("Any person who shall make or cause to be made" any false statement in an SEC filing can be subject to private liability); *see also Pinter v. Dahl*, 486 U.S. 622, 650 n.26 (1988) ("Congress knew of the collateral participation concept and employed it . . . throughout its unified program of securities regulation.").

Fifth, § 20(e), which provides supplemental SEC enforcement authority against defendants who knowingly assist the fraud of another but does not require proof of deceptive conduct, has no bearing here. In passing § 20(e), Congress chose not to restrict the scope of primary liability for persons, like respondents, who engage in their own deceptive acts. As Professor Fischel recognized in the very article the Court cited favorably in *Central Bank*, *see* 511 U.S. at 191, if aiding and abetting liability was abolished, deceptive conduct would "continue to be prohibited by the section and the rule. . . ." Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 69 CAL. L. REV. 80, 108 (1981).

Sixth, respondents' attempt to narrow the "in connection with" requirement violates *Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Dabit*, 547 U.S. 71, 85 (2006). As the Court explained in *Dabit*, it has consistently "espoused a broad interpretation" of this language. "[I]t is enough that the fraud alleged 'coincide' with a securities transaction." *Id.*; *see also O'Hagan*, 521 U.S. at 657. Where "multiple participants used or employed a deceptive device in furtherance of a scheme to misrepresent the reported revenues of a company, then all participants may be viewed as having acted in connection with

the purchase or sale of securities." *Simpson*, 452 F.3d at 1051; *see also Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000), *cert. denied*, 531 U.S. 1149 (2001) (requirement satisfied where false appearance is disseminated "in a medium upon which a reasonable investor would rely," *e.g.*, SEC filings).

VI. The Policy Arguments Raised By Respondents And Their Amici Are Improper And Factually Misleading.

Respondents concede that policy arguments cannot override the plain language of Section 10(b) and Rule 10b-5. Resp. Br. 42. Yet they and their amici devote nearly 100 pages to policy arguments that are not only matters for legislative consideration, but are factually incorrect.

Most of these arguments propose that failing to recognize a judicial safe harbor for scheme liability would have a "chilling effect" on legitimate business activity. But as we show in section I above, legitimate business activity is not reached by the test proposed here. Moreover, as respondents admit, participation by vendors and business partners in a scheme to defraud is already "deterred" by stiff criminal and civil penalties, regardless of the outcome of this case. Resp. Br. 47-48. Even attempting to execute a scheme to defraud investors can be punishable by up to 25 years in prison. 18 U.S.C. § 1348. It will frequently also constitute mail or wire fraud, *see* 18 U.S.C. §§ 1341 and 1343, and/or violate Rule 13b2-2, 68 Fed. Reg. at 31,828.

Contrary to respondents' arguments, experience shows that prohibiting corporate fraud strengthens, not weakens, the national economy. Since Sarbanes-Oxley was passed in 2002, trade figures have skyrocketed.[15] U.S. exchanges have also benefited. For example, in the first half of this year, foreign IPO listings on U.S. exchanges reached "a record rate." Thomas J. Healey, *Sarbox Was The Right Medicine*, WALL ST. J., Aug. 9, 2007, at A13. Requiring honest dealings in securities markets has clearly not "chilled" legitimate business activity.

[15] *See, e.g.*, U.S. Census Bureau trade statistics available at http://tinyurl.com/2exjde.

In addition, when it promulgatec Rule 13b2-2, the SEC found that prohibiting deceptive acts that could corrupt financial statements *enhances national competitiveness*. 68 Fed. Reg. at 31,829 "[W]e do not believe that [provisions prohibiting improper influence of auditors] would impose any burden on competition." *Id.* If they "lead to increased investor confidence in financial reporting, they also may facilitate capital formation. An increased willingness of investors to participate in the securities markets might result in issuers being able to lower their cost of capital." *Id.*

Respondents' remaining policy arguments are collateral attacks on Congress's decision to permit securities class actions. These arguments, which assert that securities class actions are ineffective and circular, have nothing whatsoever to do with the issues before this Court. Nor do these patriarchal assessments reflect the views of actual investors. Institutional investors, and member organizations of such investors, responsible for managing over *$3 trillion* in investments have filed amicus briefs supporting petitioner's position and opposing a safe harbor for schemes to defraud. In contrast, respondents' conclusions are backed only by ideological think tarks, corporate lobbyists, lawyers, and securities industry insiders – not investors.

Additionally, respondents' assertions ignore the fact that securities lawsuits have been severely constrained by the PSLRA, resulting in a "permanent shift" downward in the number of filings. Cornerstone Research, *Securities Class Action Case Filings 2007 Mid-Year Assessment* (2007), at 3 <http://tinyurl.com/32jgly>. Since 2002, the number of filings has dropped by over 50%. Cornerstone Research, *Securities Class Action Case Filings 2006: A Year in Review* (2007), at 3 <http://tinyurl.com/3dqn5o>. At the same time, the dismissal rate at the pleading stage has nearly doubled. NERA, *Recent Trends in*

Shareholder Class Action Litigation, at 4 (Jan. 2007) <http://tinyurl.com/35h55r>. Congress has already curtailed the threat of non-meritorious litigation and *in terrorem* settlements.

Especially telling is the dearth of claims against third parties. For example, *only one suit* was filed against an accounting firm in 2006. Cornerstone, *2006 Review*, at 20. This dropoff has nothing to do with the availability or prohibition of scheme liability – accountants make direct, attributed representations in every annual report and prospectus filed by each of the 6,000+ fully-filing public companies listed on the New York Stock Exchange, Nasdaq, American Stock Exchange, and OTC bulletin board.

Finally, respondents' suggestion that SEC enforcement is sufficient is undermined by the SEC itself, which voted to support petitioner in this appeal and recognized that "[m]eritorious private actions under the federal securities laws serve an important role." SEC Br. in *Simpson* at 2. Moreover, while the SEC can seek recovery for investors under its "Fair Funds" provisions, it failed to do so for Charter investors, and lacks the mechanisms to effectively distribute recovered monies. Government Accountability Office, *SEC and CFTC Penalties*, GAO 05-670, at 29 (Aug. 2005) (the SEC had then distributed only $60 million, or 1.2%, of $4.8 billion in announced recoveries) <http://tinyurl.com/269b2w>.

CONCLUSION

Respondents' deceptive conduct violated Section 10(b) and Rule 10b-5. The Eighth Circuit's limited reading of the statute to prohibit only a fraudulent statement or omission was in error and its judgment should be reversed.

Respectfully submitted,

STANLEY M. GROSSMAN
Counsel of Record
MARC I. GROSS
JOSHUA B. SILVERMAN
POMERANTZ HAUDEK BLOCK
GROSSMAN & GROSS LLP
100 Park Avenue
26th Floor
New York, NY 10017
(212) 661-1100

Attorneys for Petitioner